Office of Chief Counsel
Internal Revenue Service

memorandum

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date: January 13, 1999

to: District Director, Illinois
Attn: Leon White, Team Coordinator E:1826

from: District Counsel, Illinois CC:MSR:ILD

subject: Catalog Expense

Taxpayer: [redacted]
Mailing Address: [redacted]

EIN: [redacted]
Years: [redacted]
POA: [redacted]

I. Issue

Should paper and printing costs incurred in [redacted] for publication of an annual catalog bound and mailed in [redacted] be deducted currently, or in [redacted]?

II. Conclusions

The costs should be deducted in [redacted].

III. Facts

[redacted] company is a wholesale distributor of a wide variety of [redacted] equipment on a worldwide basis. It has published an annual catalog since [redacted]. The catalog is the taxpayer's sole point of contact with the public. It has no sales force and no independent agents.

The catalog describes thousands of items for sale. It is distributed to over [redacted] customers. The catalog issued in [redacted] was numbered [redacted]. It was printed in [redacted] and bound and

distributed in [redacted] The printer did the printing and the binding. We do not know if there was a formal contract with the printer. (The taxpayer bought the paper for the catalog from a third party and had it shipped to the printer.) The taxpayer issued separate purchase orders for the printing and the binding. The total cost for the catalog was approximately $[redacted] $[redacted] was for the paper, $[redacted] for the printing, and $[redacted] for the binding and mailing.

Expenses totaling $[redacted] for printing and other catalog services actually performed in [redacted] relating to catalog #[redacted] were deducted by the taxpayer in [redacted]. The expenses were paid no later than [redacted] The catalog expenses incurred in [redacted] represented [redacted]% of the taxpayer's annual gross income and [redacted]% of annual expenses. However, they represent [redacted] percent of the total advertising expense of $[redacted] for [redacted]

The taxpayer is an accrual basis taxpayer, and keeps records the same way for financial and tax purposes. The taxpayer was invoiced for the paper and printing in [redacted] but did not make payment until [redacted]

You have determined that the catalog has a useful life of a single year, since each [redacted] a new catalog is mailed out and replaces the prior year's catalog..

IV. Discussion

IRC § 461 governs when a liability is incurred, and when it is take into account. Under the accrual method of accounting, an expense is incurred in the taxable year in which (1) all events have occurred which establish the fact of the liability; (2) the amount can be determined and (3) economic performance has occurred. Treas. Reg. § 1.461-1(a)(2).[1] The regulation also provides that for an accrual basis taxpayer, when a liability relates to the creation of an asset having a useful life

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[1] There is no dispute about the first two requirements, and in our view, economic performance has occurred. The services of providing the paper (by the paper supplier) and the printing (by the printer) were provided in [redacted]. Binding and mailing the catalog is a separate service. This conclusion is supported by the existence of separate purchase orders for the printing and the binding. In theory, the taxpayer could have hired some other company to do the binding and mailing, so looking at it this way has some economic basis. However, if there is a contract between the taxpayer and the printer which spells out that the service to be provided by the printer is the mailing of a printed catalog, we might reach a different conclusion. Depending on exactly what the contract said, we might be able to show that the service involved is a single service not completed until [redacted]

For instance, the contract might provide that the printer will not be paid until the catalog has been mailed. Compare Treas. Reg. § 1.461-4(d)(7) *Example 4*, in which the taxpayer LP1 enters into a turnkey contract in 1990 with Z to provide a competed oil well in 1992. The $200,000 which LP1 pays Z in 1990. Economic performance occurs when the well is completed, because a turnkey contract contemplates that performance occurs when the entire operation has been completed.

extending substantially beyond the close of the taxable year, the liability is taken into account through capitalization under § 263 or § 263A.

The Service's position is that the costs of producing a catalog having a useful life of more than one year are capital in nature. Rev. Rul. 68-360, 1968-1 C.B. 197. However the ruling does not address a situation in which the costs were paid prior to the year in which the catalog was placed in service, nor does it specifically state that a catalog having a useful life of one year should be capitalized.

In some cases, courts have recognized the existence of a "one year rule," under which a deduction is allowed for costs that provide a benefit of 12 months or less even where the benefit extends over two tax years. *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1080) However, the court in *Zaninovich* observed that those cases normally involve cash basis taxpayers, not accrual basis taxpayers, and that the accrual method of accounting "aims to allocate to the taxable year expense attributable to income realized in that year."

Because the costs of paper and printing related to the production of a catalog which has benefits extending substantially beyond [redacted] and, indeed, *beginning* after [redacted] they are properly accounted for as a capital asset under § 263. The costs relate entirely to the production of income in [redacted] Indeed, not only do the benefits extend substantially beyond the year of payment, they extend *entirely* beyond the year of payment.

The taxpayer argues that the costs are currently deductible as advertising expenses, and that advertising expenses are not subject to the capitalization requirement. The taxpayer relies on *E.H. Shelton and Company v. Commissioner*, 214 F.2d 654 (6th Cir. 1954), and *Harper & McIntire Company v. U.S.* 151 F. Supp. 588 (S.D. Iowa 1957) which the Service does not follow. Rev. Rul. 68-360, *supra*. Neither does the Service agree that advertising expenses are in every instance currently deductible. *See* Rev. Rule 68-283, 1968-1 C.B. 63.

The taxpayer cites Rev. Rul. 92-80, 92-2 C.B. 57, and *RJR Nabisco Inc. v. Commissioner*, T.C. Memo 1998-252 in support of the proposition that "advertising expenses are not subject to the usual inquiry when it comes to the question of the proper time to give tax effect to such an expenditure."

Rev. Rul. 92-80 merely states that the *Indopco* decision[2] does not affect the treatment of advertising costs under § 162 (a). It does not change the treatment of advertising expenses as it existed prior to *Indopco*. To the extent that such expenses should have been capitalized before *Indopco*, they remain capitalizable after *Indopco*.

RJR Nabisco supports the government's position, not the taxpayer's. The Tax Court observed in footnote 8 to the opinion that expenditures for tangible assets associated with advertising remain

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[2] *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992)

subject to the usual rules with respect to capitalization, specifically citing its own opinion in *Best Lock Corporation v. Commissioner*, 31 T.C. 1217 (1959) and quoting "The amounts paid in 1951 and 1952 to produce *** a sales catalog were capital items contributing to earning income for several years in the future and not ordinary and necessary expenses of doing business." (at p. 1235)

The taxpayer maintains that if the costs are otherwise capitalizable, they should still be deducted entirely in the year accrued because of the recurring item exception of Treas. Reg. § 1.461-5(b). In order to be able to have the benefit of this section, the all-events and economic performance requirements need to have been met, as we conclude they have been in this case. In addition, the liability must be recurring in nature, which also true in this case.

Finally, the amount of the liability must not be material, or if it is material, deducting it in the earlier year [redacted]) must result in a better matching of the liability with income. Since it is evident that the earlier year deduction does not result in a better matching of income and liability, the question is whether the item is material.[3]

We agree with you that the amount involved is material in both the absolute sense (over $[redacted] in liabilities) and the relative sense (over 60% of advertising expenses,) as required by §1.461-5(b)(4).

This advice is subject to post-review, which should normally be finished in the next two weeks. If the National Office recommends any material change or addition to this advice, we will advise you immediately.

Richard A. Witkowski
District Counsel

By: _____
HARMON B. DOW
Special Litigation Assistant

cc: Assistant Chief Counsel (Field Service) CC:DOM:FS
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[3] Since the taxpayer reports for tax and financial purposes in the same manner, we cannot rely on how it reported this item for financial purposes in order to determine materiality. Treas. Reg. § 1.461-5(b)(4)(ii) and (iii)

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